Tax Implications of Short Sales

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What is a Short Sale?

- A short sale occurs when a mortgage company or lender agrees to accept less than they are owed for an outstanding loan.

How Does This Work?

- Basically, the homeowner is negotiating with the lender.
- The homeowner requests to be allowed to sell the home for less than the debt he owes.

What Is the Difference Between a Short Sale and Foreclosure?

- In a short sale, the homeowner sells the house. In a foreclosure, the lender takes ownership of the property and sells it.
- Foreclosure stays on your credit for up to seven years and can make it difficult to obtain another loan. Conducting a short sale minimizes the damage to your credit.

Tax Relief for Distressed Homeowners

- Homeowners experiencing “short sales” and cancellation of debt will get an extended break for “debt-forgiveness” tax consequences. Instead of treating cancellation of debt as taxable income from the foreclosure of a principal home, no taxes will be levied on discharges of indebtedness of up to $2 million dollars for married taxpayers filing jointly and of up to $1 million dollars for a married taxpayer filing a separate return through tax year 2012 if certain conditions exist.

Will the Lender Issue a Form 1099 to the Homeowner?

If the remainder or unpaid portion of the debt is forgiven and will not have to be repaid, the homeowner should receive a Form 1099-C, *Cancellation of Debt,* for the amount forgiven (if $600 or more).

Will Homeowners Owe Tax on the 1099-C Amount If This Was Their Main Home?

- Yes, unless they meet section 121 conditions, are insolvent, or in bankruptcy.
- Section 121 allows an individual to exclude up to $250,000 ($500,000 if MFJ)of gain on the sale of their personal residence, as long as they have owned, and lived in, the residence for 2 of the last 5 years.
- Exceptions for “unforeseen circumstances” allow a reduced exclusion.
- If there is a loss on the sale, it is a personal loss & cannot be claimed on the tax return.

Will the Homeowners Owe Tax if the 1099-C is for a Refinance Loan?

- They could.
- If their refinance resulted in a loan that was in excess of the home's cost basis, that excess would not be eligible for the exclusion.
- If the equity was received and not used on the primary home.
- Loaned amounts associated with the home itself may qualify for the section 121 exclusion.

What about business property, such as a copier used in a business or a house owned 100% for rental?

- The disposition of business property, whether a building or personal property, is reported on Form 4797, *Sales of Business Property*.
- Gain on depreciated property can be ordinary income if due to depreciation.
- Loss on business property is applied in the year of the disposition.

Will the Taxpayer Owe Tax on 1099-C For Investment Property?

- If the property was investment property purchased with the intent to hold and resell when the value rises, such as undeveloped land or collectibles, and
- If the taxpayer has debt forgiveness, there will be ordinary income on the return.
- If the property is sold at a loss, the homeowner would be eligible to take the loss (subject to $3,000/ $1,500 annual loss limit).

So, How Much Does the Taxpayer Owe the IRS?

- The tax liability depends on the individual scenario and tax bracket.
- Debt forgiveness is ordinary income.
- Depreciation recapture is ordinary income. If part of a main home was used for business use, it affects the classification of gain as sec. 1250 gain.

Refinance Short Sale Example

Three years ago, Tracy Taxpayer purchased a home for $500,000 with a $425,000 mortgage. Last year, when the home was worth $700,000, Tracy refinanced it with a $600,000 mortgage.

Tracy defaulted on the mortgage at a time when the house is worth only $525,000 on the volatile home market.

Tracy sold the home for $525,000 and walked away from the mortgage. The result is that Tracy’s tax return shows a $25,000 capital gain, excluded by section 121, and a taxable $75,000 in debt forgiveness.

Short Sale Example

Homeowner Lesley paid $500,000 for a home that he later had to sell for $425,000, with a mortgage balance of $510,000.

- For tax purposes, he has a nondeductible $75,000 loss on the sale but still owes the lender $85,000.
- If the lender refuses to discharge the balance due, Lesley is still liable to pay the remaining debt.
- If the lender forgives the unpaid $85,000, Lesley will receive Form 1099-C with that amount and report it as taxable income on this year's tax return.

Questions?

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